No. 15447

United States
COURT OF APPEALS
for the Ninth Circuit

GRACE M. POWELL, Executrix of the Estate of O. E. POWELL, Deceased,

Appellant,

vs.

RALPH C. GRANQUIST, District Director of Internal Revenue,

Appellee.

On Appeal from the Judgment of the United States District Court for the District of Oregon

BRIEF FOR THE APPELLANT

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STATUTES

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OPINION BELOW

The District Court rendered its opinion, which is reported 145 Fed. Supp. 308 (R. 77-84). Its findings of fact and conclusions of law (R. 84-88) are unreported.

JURISDICTION

Grace M. Powell is the duly appointed and qualified executrix of the Estate of O. E. Powell who died on July 16, 1954 (R. 3).

Deficiencies of income tax for 1937, 1938, 1939, 1940, 1941, 1942, 1943, 1944, 1945, were assessed by the Commissioner of Internal Revenue against O. E. Powell (R. 4, 6, 9, 11, 14, 16, 19, 22, 25). All of the amounts in dispute in this proceeding have been paid by Grace M. Powell, Executrix of the Estate of O. E. Powell herein, and/or O. E. POWELL, and were so paid prior to filing the claims for refund (R. 5, 8, 10, 12-13, 15, 18, 21, 24, 27). On or about July 15, 1954, O. E. Powell filed a timely claim for refund for each of the taxable years in controversy (R. 5, 8, 10, 12-13, 15, 18, 21, 24, 27). The District Director of Internal Revenue, appellee herein, mailed to the taxpayer on or about October 7, 1954, his notice of disallowance in full of all of the said claims for refund by registered mail (R. 5, 8, 10-11, 13, 15-16, 18, 21, 24, 27), and thereafter this suit was commenced in the United States District Court for the District of Oregon for the recovery of all of the amounts in controversy, within the time provided in Section 3772 of the Internal Revenue Code of 1939 (R. 70). Jurisdiction was conferred on the District Court by 28, U.S.C. Section 1340 (R. 3, 6, 9, 11, 14, 16, 19, 22, 25). This case was tried before the United States District Court for the District of Oregon and judgment was entered in part for Appellees on December 26, 1956 (R. 89). Within 60 days thereafter, January 9, 1957, notice of appeal was filed from so much of the decision that was rendered against Appellant (R. 90). Jurisdiction is conferred on this Court by 28 U.S.C. Section 1291.

QUESTIONS PRESENTED

Whether the United States District Court for the District of Oregon erred in concluding and holding that deficiencies in income taxes assessed by the Commissioner of Internal Revenue against O. E. POWELL and collected by the Appellee herein for the years 1937 through 1945, inclusive, were due to fraud with intent to evade the tax within the meaning of Section 293 (b), Internal Revenue Code of 1939, and that the collection of $12,880.39 from ORA E. POWELL and/or the Appellant herein by the Appellee of the amount of the penalty imposed by Section 293 (b), Internal Revenue Code of 1939, for the years 1937 through 1945, inclusive were proper by reason of the fact that the Appellee failed to sustain his burden of proving fraud by clear and convincing evidence.

STATEMENT

The pertinent facts as found by the District Court are as follows (R. 77-80):

The taxpayer received taxable income for the years 1937 through 1945, inclusive, but filed no federal income tax returns for those years. Failure of the taxpayer to file income tax returns came to the attention of the Internal Revenue Service in January, 1946; whereupon an investigation was begun to determine the taxpayer's taxable income for the years involved. During the years 1937 to 1945, taxpayer owned and operated a number of gasoline service stations, later leasing them to the two

sons, Lee G. Powell and Vincent O. Powell, receiving from them rental incomes. Also taxpayer, at various times during that period, had 19 different properties that he rented, and also during that time, he made in excess of 30 real estate sales, farms and residences, and also had interest income on contracts and commissions from realty sales. In order to determine taxpayer's income, it was necessary that the Internal Revenue agent search public records of four counties, determine from the sons how much they leased the stations for, and contact real estate agents and other parties to the various transactions. This was necessary because taxpayer had indicated that he kept no records (R. 77-78).

Deficiencies in income tax were ultimately determined and assessed for 1937 through 1945, together with fraud penalties and penalties for failure to file declaration of estimated tax and for substantial underestimated tax. The amounts assessed as tax are not in controversy here, but only the correctness of the assessment of the 50% fraud penalty. At the time of trial, counsel for the taxpayer conceded the 25 per cent penalty for willful failure to file income tax returns (R. 78).

This case does not involve income tax returns fraudulently filed, but rather is concerned with the situation where there was no tax return filed at all (R. 79).

The evidence disclosed that Mr. Powell, during this period, with his failure to file, made it known that he was not in sympathy with the administration and did not like the way the government was run and did not believe in paying taxes (R. 80).

The taxpayer's son testified that he told his father that he should be paying income taxes, that it was the thing for him to do, and he, the father, said he knew it, but didn't pay because he didn't believe in the way the government was raising money; he said he believed in taxation, but didn't believe that the government should waste the money. His failure to file returns was based primarily upon political convictions (R. 80-81).

There is no evidence in the record of alteration or concealment of bank statements, cancelled checks or real estate contracts by the taxpayer. Mr. Powell said he did not have records, and there is no evidence of these having been destroyed or falsely made. The records which Powell kept were adequate for him to carry on his business profitably, yet Powell never volunteered any records, information or contracts. His only and various transactions were discovered by Internal Revenue Agents on specific requests made for all records and documents pertinent thereto, they were made by the taxpayer (R. 81).

From the evidence presented, and the record herein, it was found that the following factors were present to some degree in this case: Gross understatement of income, failure to keep proper books and records, failure to cooperate with investigating agents, and the giving of evasive answer (R. 79).

STATEMENT OF POINTS TO BE URGED

1. There is no evidence to support the Findings of Facts No. 8 (R. 86) and the District Court was in error in making such a finding, which asserts:

> "Ora E. Powell did not keep books and records adequate to show his income during the years 1937 through 1945."

2. There is no evidence to support the Finding of Fact No. 10 (R. 87) and the District Court erred in making such a finding which asserts:

> "Ora E. Powell gave evasive answers to the Internal Revenue Agents attempting to ascertain his taxable income for the years 1937 through 1945, and did not cooperate with the agents in their investigation."

3. There is no evidence to support the Finding of Fact No. 11 (R. 87) and the District Court erred in making such a finding which asserts:

> "The failure of Ora E. Powell to file any federal income tax returns for the years 1937-1945 was knowingly, willful and intentional, and was due to fraud with intent to evade tax."

4. There is no evidence to support the Conclusion of Law No. 4 (R. 87-88) and the District Court erred in making such a conclusion which held:

> "Deficiencies in income tax assessed by the Commissioner of Internal Revenue against Ora E. Powell for the years 1937-1945 were due to fraud with intent to evade tax within the meaning of Section 293 (b) Internal Revenue Code, and the 50 per cent defraud penalty assessed against Ora E. Powell by the Commissioner of Internal Revenue for the years 1937-1945, were proper."

SUMMARY OF ARGUMENT

The District Court erred in finding that the 50 per cent fraud penalty assessed pursuant to Section 293 (b) Internal Revenue Code of 1939, for failure of O. E. Powell to file income tax returns was proper. The Appellee failed to sustain his burden of proving by clear and convincing evidence that the deficiency in income tax for each of the taxable years involved herein was due to fraud with intent to evade tax and accordingly the decision rendered below should be reversed.

The Commissioner must sustain his burden of proof, by clear and convincing evidence to sustain the assessment of the fraud penalty pursuant to Section 293 (b) Internal Revenue Code of 1939. The record in this case is wholly bare of the usual indicia of fraud. The factors which usually are considered to be badges of fraud are: (1) Keeping a double set of books; (2) making false entries or alterations; (3) false invoices or documents; (4) destruction of books or records; (5) concealment of assets or covering up sources of income; (6) handling of own affairs to avoid the making of records usual in transactions of this kind; (7) any conduct, the likely effect of which would be to mislead or to conceal.

ARGUMENT

The Failure to File Income Tax Returns Does Not Justify the Imposition of the Fraud Penalty

The Court below in concluding (R. 82) that the imposition of the 50% fraud as imposed by Section 293

(b), Internal Revenue Code of 1939, in addition to the 25% penalty for failure to file income tax returns as imposed by Section 291 (a), Internal Revenue Code of 1939, was proper said:

> "Here Mr. Powell's omission was not accidental. It was purposeful, wilful and deliberate omission to file and pay income taxes. Should this court hold that there was no fraud with intent to evade taxes in this case, it would open the door to all who desire to evade taxes to escape the fraud penalty by wilfully and deliberately failing to file. . . ."

The above observations are incompatible with those sections of the Internal Revenue Code of 1939 which set up the statutory scheme for the imposition of civil penalties for the various omissions of taxpayers. Bear in mind that the taxpayer *paid the penalty for failure to file his income tax return and has admitted that this penalty was proper*. The teachings of the Supreme Court of the United States militates against the construction placed on the statutes by the court below. The Court of Appeals for the 8th Circuit, the only other court to pass directly on the issue posed here held that only the lesser penalty was proper and held that the 50% fraud penalty was improper. These decisions are discussed infra.

Compare the structure of the criminal sections of the Internal Revenue Code with the structure of the civil section. Section 145 (a) makes it a misdemeanor to wilfully fail to file a return; while section 145 (b) makes it a felony to ". . . wilfully attempt in any manner to evade or defeat any tax . . ." These sections have been construed by the United States Supreme Court to

have definite meaning in our tax system. The mere wilful failure to file a return, no matter how wilful, is punishable only as a misdemeanor. *Spies v. U. S.*, 317 U.S. 492. The court in making its distinction between Section 145 (a) and 145 (b) said:

> "The difference between willful failure to pay a tax when due, which is made a misdemeanor, and willful attempt to defeat and evade one, which is made a felony, is not easy to detect or define. *Both must be willful, and willful, as we have said, is a word of many meanings,* its construction often being influenced by its context. *United States v. Murdock,* 290 U.S. 389. It may well mean something more as applied to nonpayment of a tax than when applied to failure to make a return. Mere voluntary and purposeful, as distinguished from accidental, omission to make a timely return might meet the test of willfulness. But in view of our traditional aversion to imprisonment for debt, we would not without the clearest manifestation of Congressional intent assume that mere knowing and intentional default in payment of a tax where there had been no willful failure to disclose the liability is intended to constitute a criminal offense of any degree. We would expect willfulness in such a case to include some element of evil motive and want of justification in view of all the financial circumstances of the taxpayer.
>
> "Had § 145 (a) not included willful failure to pay a tax (it would have defined as misdemeanors generally *a failure to observe statutory duties to make timely returns,* keep records, or suppy information—duties to facilitate administration of the Act even if, because of insufficient net income there were no duty to pay a tax. It would then be a permissible and perhaps an appropriate construction of § 145 (b) that it made felonies of the same willful omissions when there was the added element of duty to pay a tax. The definition of such nonpay-

ment as a misdemeanor we think argues strongly against such an interpretation." (Emphasis added.)

In comparing Sections 145 (a) and 293 (b), note that the language is similar. The offense is described in Section 145 (b) as ". . . any person who willfully attempts in any manner to evade or defeat any tax . . ." and in Section 293 (b) "If any part of the deficiency is due to fraud with intent to evade tax . . ." The latter civil section uses stronger language than the criminal section. The civil section speaks of *fraud*. In the *Spies* case, supra, the court in commenting on the terminology of Sections 145 (a) and 145 (b) said:

> "The difference between the two offenses, it seems to us, is found in the affirmative action implied from the term "attempt," as used in the felony subsection. It is not necessary to involve this subject with the complexities of the common law "attempt." The attempt made criminal by this statute does not consist of conduct that would culminate in a more serious crime but for some impossibility of completion or interruption or frustration. This is an independent crime, complete in its most serious form when the attempt is complete and nothing is added to its criminality by success or consummation, as would be the case, say, of attempted murder. Although the attempt succeed in evading tax, there is no criminal offense of that kind, and the prosecution can be only for the attempt. *We think that in employing the terminology of attempt to embrace the gravest of offenses against the revenues Congress intended some willful commission in addition to the willful omissions that make up the list of misdemeanors.* Willful but passive neglect of the statutory duty may constitute the lesser offense, but to combine with it a willful and *positive attempt to evade tax in any manner or to defeat it by any means lift the offense to the degree of felony.*" (Emphasis added.)

The court required "willful commissions" distinguished from "willful omissions." By way of illustrating the court cited conduct which would qualify as "willful commission:"

> "Congress did not define or limit the methods by which a willful attempt to defeat and evade might be accomplished and perhaps did not define lest its effort to do so result in some unexpected limitation. Nor would we by definition constrict the scope of the Congressional provision that may be accomplished "in any manner." By way of *illustration, and not by way of limitation, we would think affirmative willful attempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income,* handling of one's affair to avoid making the records usual in transactions of this kind, and any conduct, the likely effect of which would be to mislead or to conceal. If the tax evasion motive plays any part in such conduct the offense may be made out even though the conduct may also serve other purposes such as concealment of other crime." (Emphasis added.)

In *First Trust & Savings Bank v. United States,* 206 Fed. (2d) 97, a case holding that only the 25% penalty for the *willful failure* to file income tax returns was proper, noting the distinction between the felony section of the Internal Revenue Code (Section 145 (b) and the misdemeanor section of the Internal Revenue Code (Section 145 (a) and citing the *Spies* case, supra, held that the *"willful failure* to file returns by the taxpayer did not justify the imposition of the 50% penalty imposed by Section 293 (b) Internal Revenue Code of 1939 as contended by the defendant, but was penalized

by the 25% penalty imposed by Section 291 (a), Internal Revenue Code. Mr. Powell paid the 25% penalty and the propriety of its imposition is not questioned. In the case cited immediately preceding the Court in emphasizing this distinction said:

> "But although this case comes to us as one of *first impression with no cited precedent* to support the judgment so far as the identical issue is concerned, the teaching of the opinions that have been handed down with controlling authority in criminal cases establishes that in the "structure of civil and criminal sanctions" which Congress has provided for collection of income taxes, *the "wilful failure" to file returns by the taxpayer in this case must be held to fall in the category of lesser civil derelictions calling for the smaller "addition to tax"* as well as constituting a minor and not a major criminal offense. The applicable principles were clearly defined by the Supreme Court in *Spies v. United States,* 317 U.S. 492, and in the opinion of this court in *Cave v. United States,* 159 Fed. (2) 464. (Emphasis added.)
>
> * * * * *
>
> *"The distinction between the lesser and the graver derelictions which govern the larger and the smaller civil additions to tax is of exactly the same character as that found by the Supreme Court in respect to the criminal penalties.* Manifestly *wilful failure* to file returns may have the same effect on the collection of the revenue as *an attempt to evade a tax.* But Congress makes the difference on the *civil side* as it does on the *criminal side,* between the taxpayer whose deficiencies of tax are due to (or caused by) his *affirmative commission* of fraud and the one whose deficiencies of tax due to *wilful omission to make returns.* That omission justifies the addition of 5 per cent up to 25 per cent of the deficiencies found against the taxpayer *but does not afford any basis for the addition of 50 per cent to his deficiencies.* Only the commission of acts of fraud with

intent to evade tax to which "the deficiencies are due" (or which bring about the deficiencies) affords a basis for the 50 per cent addition to tax. (Emphasis added.)

"The teaching of the opinion of this court in *Cave v. United States,* 159 Fed. (2) 464 is to the same effect as that of the Supreme Court in the *Spies* case."

The Imposition of the Fraud Penalty Requires Wilful Commission

The only prior precedent on the issues raised by this appeal hold that the "wilful omission" to make a return justifies the 25% penalty but does not justify the imposition of the 50% penalty. Reemphasizing the *First Trust and Savings Bank* case, supra, we requote:

> "But Congress makes the difference on the civil side as it does on the criminal side, between the taxpayer whose deficiencies are due to (or caused by) his *affirmative commissions of fraud* and the one whose deficiencies are due to *wilful omission to make returns.* That *omission* justifies the addition of the 5 per cent up to the 25 per cent of the deficiencies found against the taxpayer but does not afford any basis for the addition of 50 per cent to his deficiencies. Only the commission of acts of fraud with intent to evade tax to which "the deficiencies are (or which bring about the deficiencies) affords a basis for the 50 per cent addition to tax." (Emphasis added.)

A reading of the opinion (R. 77-84) does not disclose a single finding of *wilful commission* as those words are defined in the *Spies* case, supra. The Supreme Court of the United States said:

> ". . . By way of illustration, and not by way of limitation, we would think affirmative wilful at-

> tempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling one's affairs to avoid making the records usual in transactions of this kind, and any conduct the likely effect of which would be to mislead or to conceal. . . ."

The Court below made a direct finding that there was no evidence of such conduct (R. 81). In passing on this element of evidence the court said:

> "There is no evidence in the record of *alteration* or *concealment* of bank statements, cancelled checks or real estate contracts by the taxpayer. Mr. Powell said he did not have records, and there is no evidence of these having been *destroyed* or falsely made. . . ." (Emphasis added.)

Note that the court found records were available to reconstruct the taxpayer's income as he had recorded his real estate transactions in the public records showing that he made no attempt to conceal his principal activity (R. 77-78).

It is interesting to note that the court below went on to say (R. 81):

> ". . . However, there is no need for him to make false records or destroy records in contemplation of an investigation by the Internal Revenue Service, when the taxpayer wasn't making or filing any income tax returns."

This statement seems pregnant with an assertion that all that is necessary for the imposition of the 50% fraud penalty was the failure to file tax returns.

Fraud in a case of this character must be established

by clear and convincing proof, *Rogers v. Commissioner,* 111 Fed. (2d) 897; *Jemison v. Commissioner,* 45 Fed. (2d) 4; *Owens v. U. S.,* 98 Fed. Supp. 621, *Affd.* 197 Fed. (2d) 450. The burden of establishing fraud by *clear and convincing evidence is upon the defendant. Ohlinger v. U. S.,* 219 Fed. (2d) 310. The fraud mentioned in the statute must be an overt wrongdoing with intent *to evade a tax* believed to be owing. *Mitchell v. Commissioner,* 118 Fed. (2d) 308; *Wisley v. Commissioner,* 185 Fed. (2d) 263.

The *First Trust and Savings Bank* case, supra, is on all fours with this case. In that case, the taxpayer paid the fraud penalty asserted and sued out a claim for refund of said penalty. Taxpayer in that case failed to file income tax returns for eight years, even though he had taxable net income comparable to O. E. Powell. His records were comparable to those kept by O. E. Powell. His cancelled checks and deposit records were available at the bank as were those of O. E. Powell. He was informed against under Section 145 (a) Internal Revenue Code for wilfully failing to make an income tax return required of him for 1945, to which information he pleaded guilty and was sentenced.

The Court of Appeals for the 8th Circuit in commenting on the evidence said:

> "There was no proof of any wilful commission of any *affirmative act* of fraud on the part of the taxpayer to evade the taxes which he admitted he owed and ought to have filed return for during the years in question. His plea of guilty to the charge of wilfully failing to make and file return was of course evidence against him of the elements of that charge.

> It was compatible with all the other evidence in the case that his dereliction consisted only in *wilful omission and passive neglect* to perform the duty of making returns imposed upon him by law." (Emphasis added.)

The court in holding that the 50 per cent fraud penalty was improper said:

> ". . . Congress distinguishes between the taxpayer who is guilty of mere *passive failure* to perform his duty in respect to a tax owing by him and the taxpayer is guilty of *affirmative attempt* or practice of fraud to evade such tax. Though 25 per cent addition to tax was correctly added to Mr. Kraftmeyer's deficiencies because he *wilfully failed and continued to fail to make returns* required of him, the 50 per cent assessment was erroneously made because his dereliction was *passive* and *included no affirmative act of fraud that caused his tax deficiency. His deficiencies were not 'due to fraud with intent to evade tax'.*" (Emphasis added.)

It is significant that this court required an *affirmative act* as distinguished from mere *passive conduct,* and made the finding that the taxpayer "wilfully failed and continued to wilfully fail to make returns required of him." The court below in distinguishing the present case from the *First Trust and Savings Bank* case remarked:

> "The case cited and the present case differ in that the taxpayer (Mr. Kraftmeyer) in the *First Trust and Savings Bank* case, *wilfully failed to make* returns required, had never been informed that he was required to file a return, and apparently was under the impression that he had no taxable income, and did not know that he owed any tax. . . ."

These observations are in part incompatible because if the taxpayer in that case *wilfully failed* to file a return he would have to know he was required to file and had

taxable income. The court made a direct finding that he wilfully failed to file income tax returns and he pleaded guilty to a criminal charge under Section 145 (a), Internal Revenue Code, for wilfully failing to file income tax returns.

An examination of the record fails to disclose a scintilla of evidence establishing a *wilful commission* of an act on the part of O. E. Powell as distinguished from *passive conduct*. The only evidence offered by the government was a failure of Mr. Powell to keep formal books and records and a claimed failure of cooperation. However, the failure to cooperate in *1948, 1949 and 1950* does not in itself establish an active wilful commission as distinguished from passive conduct from *1937 through 1945*. In the *First Trust & Savings Bank Case,* supra, Kraftmeyer also failed to maintain books and records and gave false answers regarding duplicate copies of his tax return, implying to the examining agent that he had such documents. This fact is incompatible with Kraftmeyer's assertion that he did not know he owed taxes and his ignorance of his requirement to file returns.

The records of this present proceeding is bare of any evidence of "some wilful commission." The defendant has failed to sustain his burden of proof, *Ohlinger v. United States,* supra, by clear and convincing evidence, *Rogers v. Commissioner,* supra; *Jemison v. Commissioner,* supra. Since there has not been a "wilful commission" as distinguished from "passive conduct" this case should be governed by the same rationale as employed in *First Trust and Savings Bank* case, supra, in which case the court held:

"In the *Spies* case, the conviction for felonious attempt to evade tax was reversed because the necessary showing of '*some wilful commission*' was lackin."

* * * * *

"*There is the same necessity to distinguish between the two kinds of dereliction of taxpayers for which Congress has provided different percentages of addition to tax.* The same reasoning establishes that the lesser 5 to 25 per cent additions to tax provided in respect to 'deficiencies due to negligence or intentional disregard of rules and regulations' or for 'failure to make and file return * * * due to wilful neglect' by sections 293 and 291, were applicable to the taxpayer in this case."

CONCLUSION

For the reasons stated above the imposition of the 50% fraud penalty was improper for the mere failure on the part of the taxpayer to file income tax returns for the years 1937 through 1945, inclusive and the Appellee failed to prove by clear and convincing evidence any acts of commission which would sustain the imposition of the 50% fraud penalty as imposed by Section 293 (b), Internal Revenue Code of 1939. That portion of the judgment below denying Appellant recovery of the penalties imposed and paid should be reversed.

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